How might Matching Defined Contributions help improve social protection design and labor market outcomes in MDCs?

Ian Walker , The World Bank

Motivation and main messages

Adapting social protection to labor market realities

- **“ In general, there is a need to rethink social insurance programs and adapt them to labor market dynamics.** Given the mobility of the labor force across occupations and between the formal and informal sectors, contributory systems that cover only formal sector workers are insufficient. However, having a parallel contributory and non-contributory system does not seem to be the most efficient strategy either. Thus, policymakers need to come up with integrated systems that do not discriminate between workers depending on where they work (sector or occupation), while ensuring that the design encourages, rather than discourages, formal sector work.” (RRW, p.83)

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Policy question

- How can we expand the coverage of contributory social insurance while minimizing labor market distortions and ensuring horizontal equity?
- Target group: *informal workers,* outside SI, on whom we are unable to impose savings mandates.
- Specific target group: informal workers *with some savings capacity*: the "*missing middle*" between formal sector and extreme poor beneficiaries of targeted anti poverty programs.

Main messages (1)

- "**Bismarkian**" systems are flawed:
  - Low coverage, exclude informal sector and self-employed.
  - Redistribution is non-transparent and often regressive.
  - Tax element of contributions distorts labor markets, foments informality.
- Parallel **non-contributory** systems help, but have drawbacks:
  - Create a "two-tier" system in terms of benefit levels.
  - Create further incentives for informality.
  - Fail to achieve complete coverage (" missing middle").

Main messages (2)

- Ideal solution: a **universal integrated system**:
  - Anybody can enroll.
  - Contributions linked to benefits.
  - Redistribution is explicit and targeted based on needs.
  - Financing is through contributions plus general taxation.
- But that might be hard to get, for myriad reasons
- **Alternative :**
  - Extend reformed contributory arrangements into the informal sector.
  - Thereby, limit the scope of the non-contributory system.
  - Matching defined contributions can be a key incentive.

Outline

- Typology of social insurance systems and the problem of coverage.
- Labor market distortions imposed by SI systems.
- A general policy framework to design and expand SI coverage.
- Potential role of MDCs

TYPOLOGY OF SI SYSTEMS AND THE PROBLEM OF COVERAGE

Mapping SI systems

RISK - PROGRAMS	INSTRUMENTS	FINANCING MECHANISMS
Pensions	Savings	Pay-roll taxes
Old-age Disability Survivors	Risk-pooling (insurance)	Individual contributions
Unemployment benefits	Redistribution	General revenues
Health benefits	Explicit Implicit	

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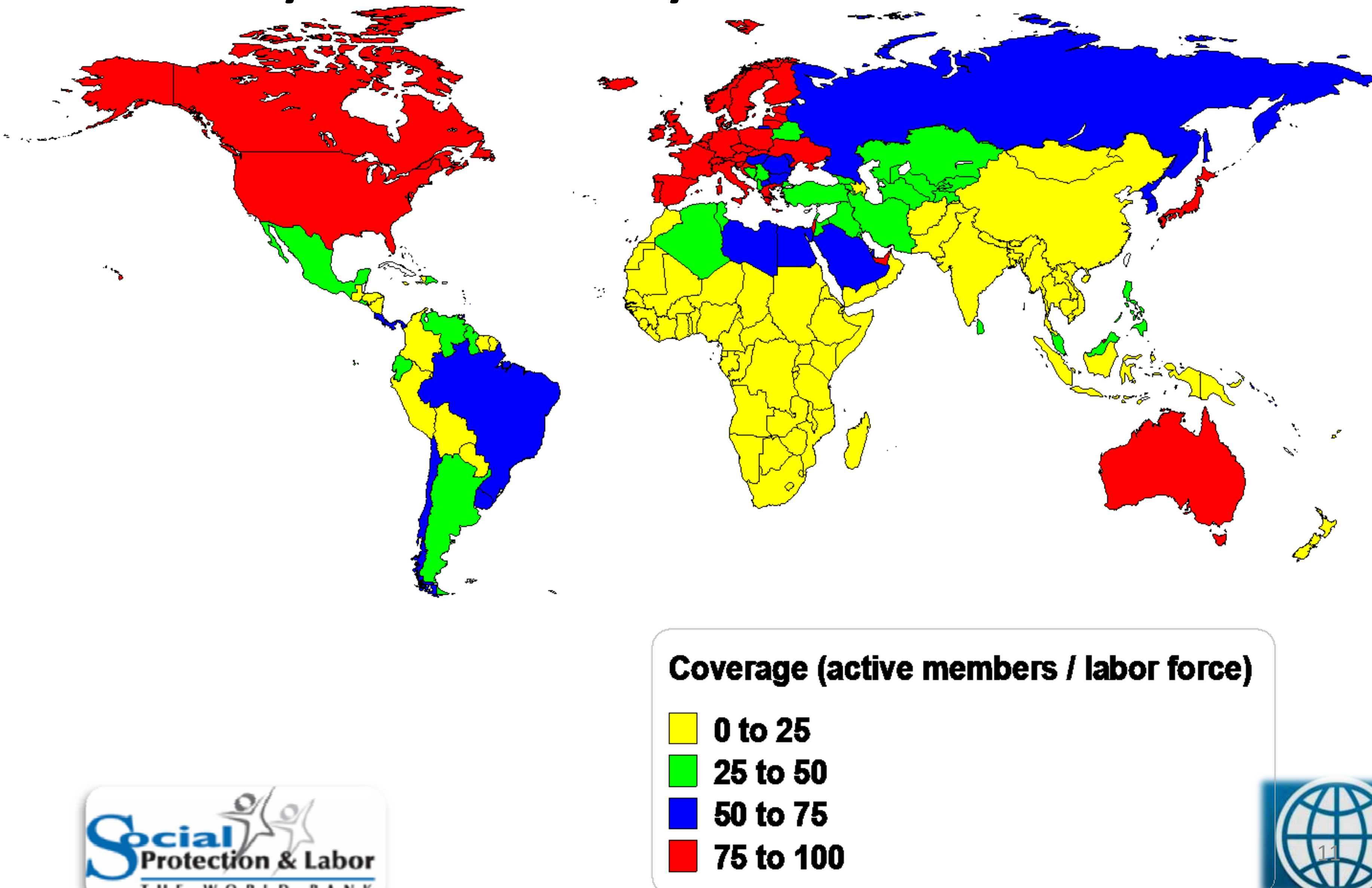
Systems that we observe

Pensions	Defined Benefit (risk-pooling) (pay-roll and IC) (implicit redistribution)	Defined Contributions (savings) (pay-roll and IC) (explicit redistribution)	
Unemployment benefits	Severance Pay (risk-pooling) (employer tax) (implicit redistribution)	Unemployment Insurance (risk-pooling) (pay-roll and IC) (implicit redistribution)	Unemployment Savings Accounts (savings) (pay-roll and IC) (explicit redistribution)
Health benefits	Social H. Insurance (risk-pooling) (pay-roll and IC) (implicit redistribution)	National Health Services (risk-pooling) (general revenues) (implicit redistribution)	Health Savings Accounts (savings) (pay-roll and IC) (explicit redistribution)

Only a minority has access to SI



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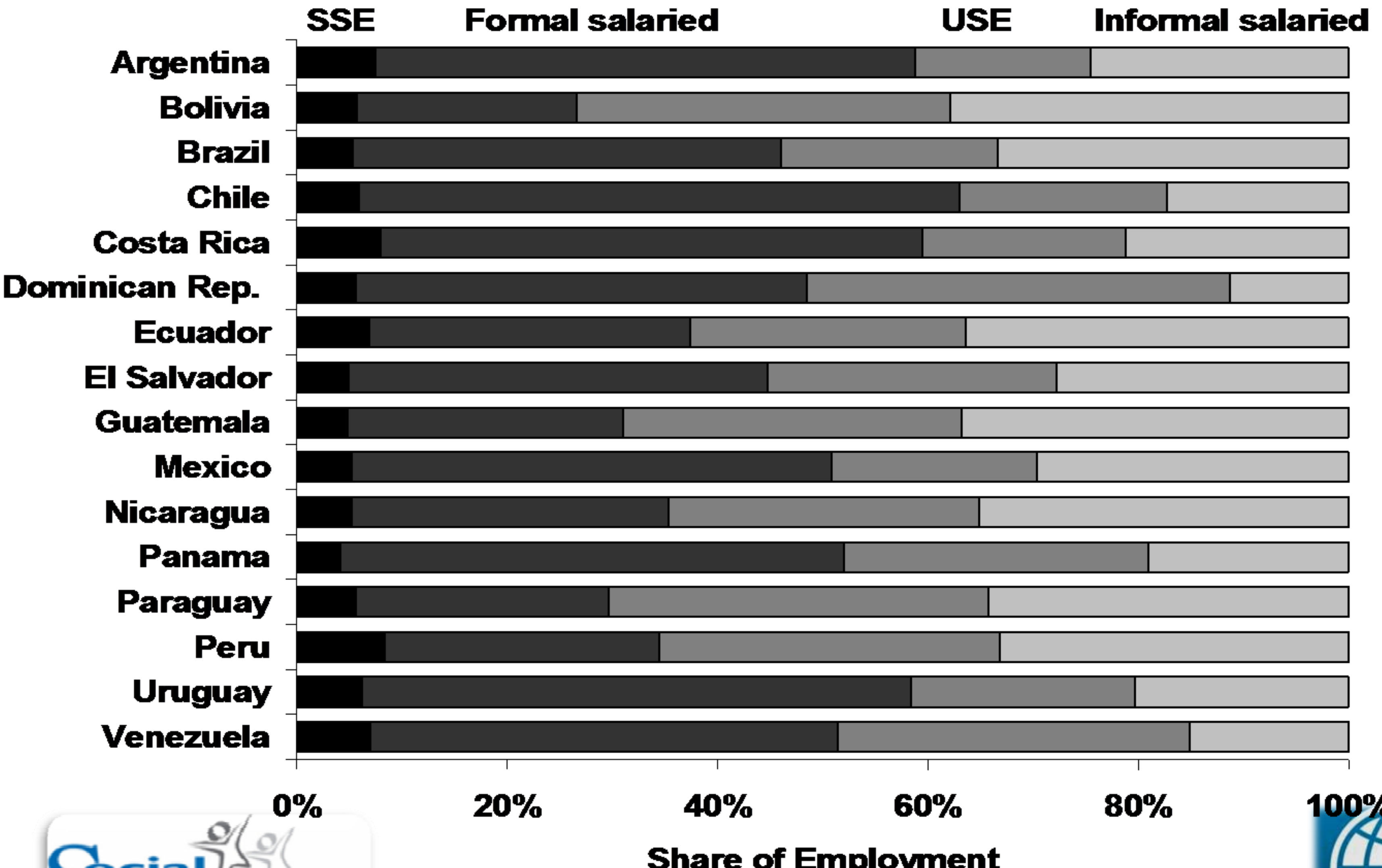
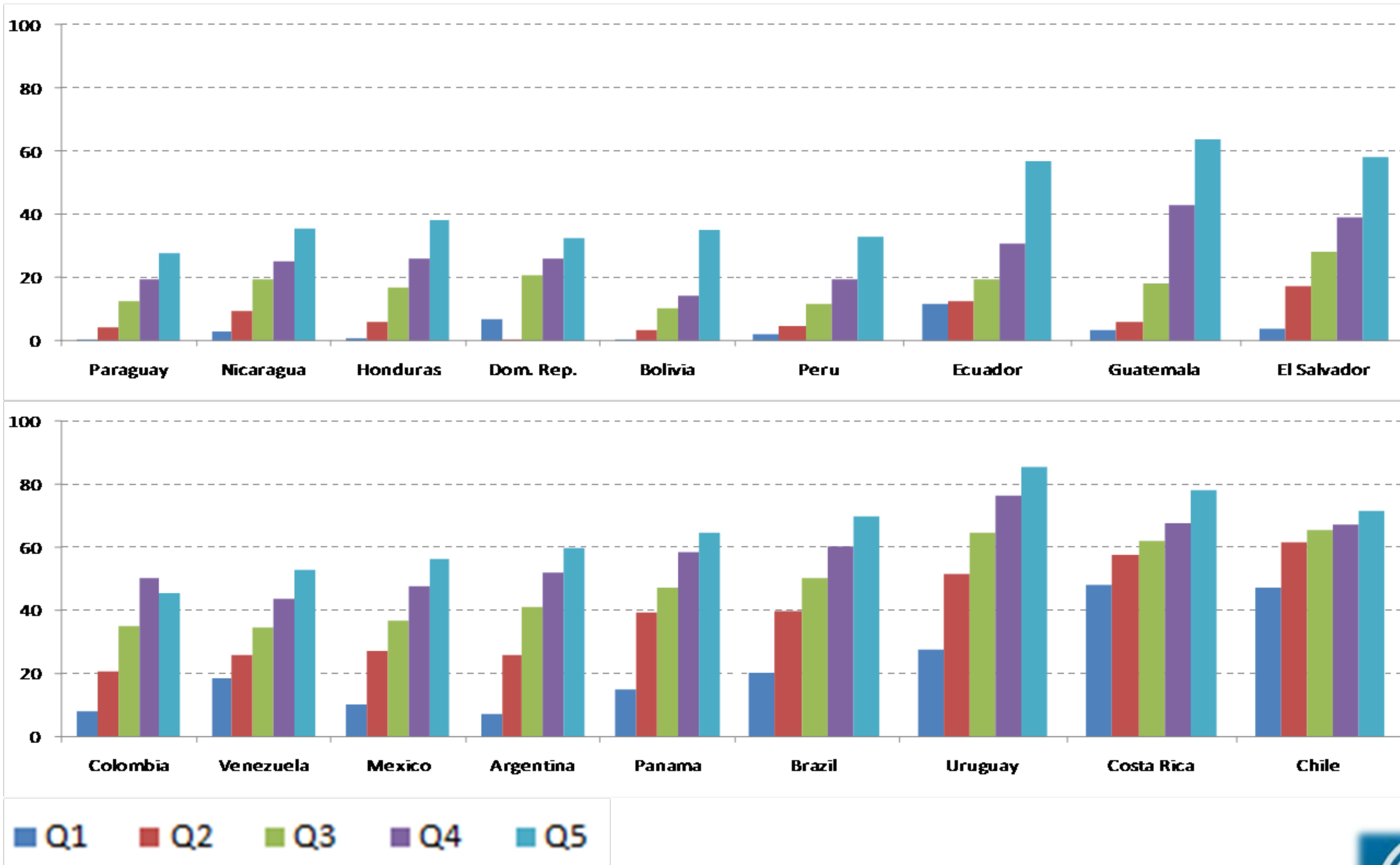
Informality is part of the problem



Coverage is also correlated with income



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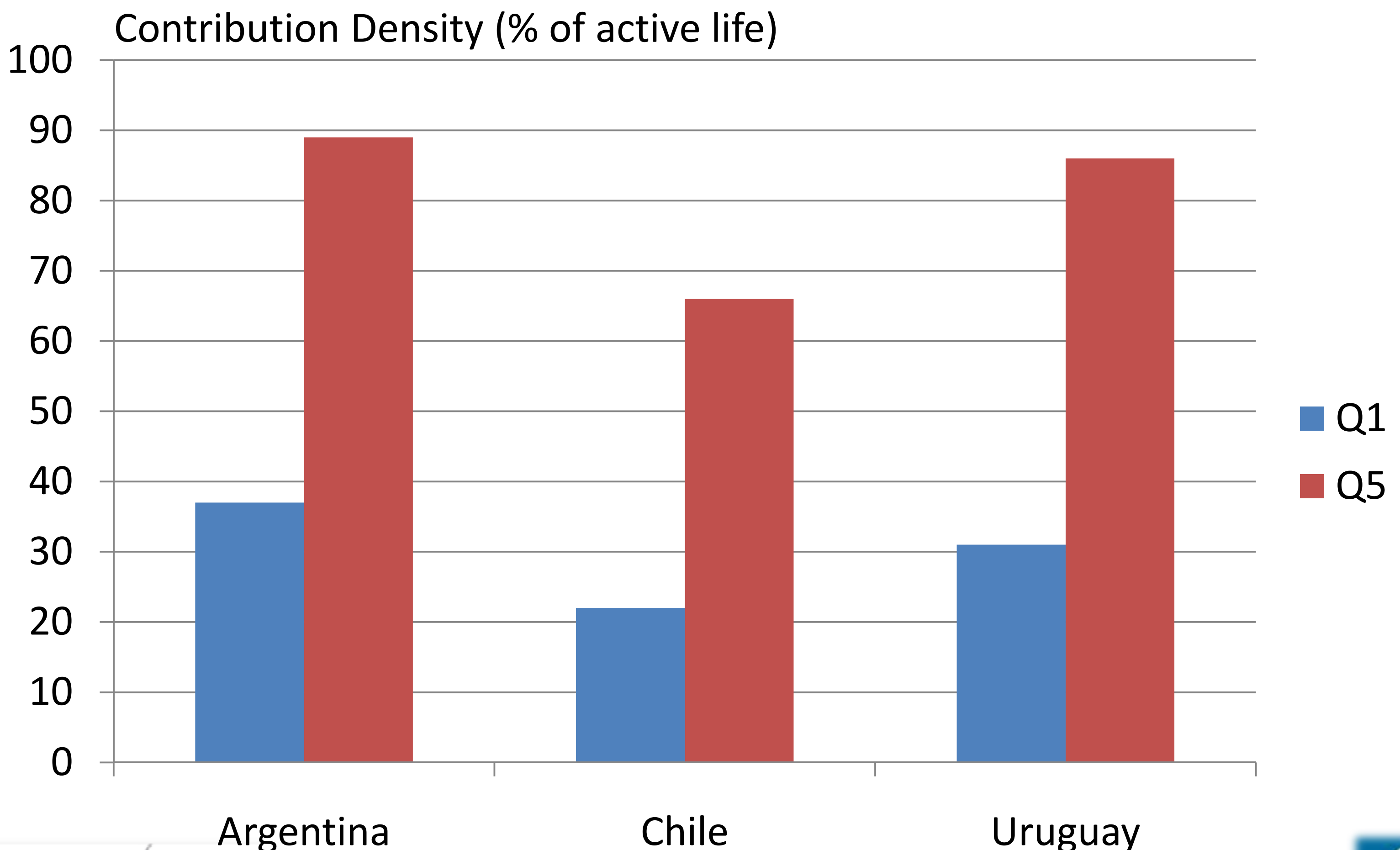
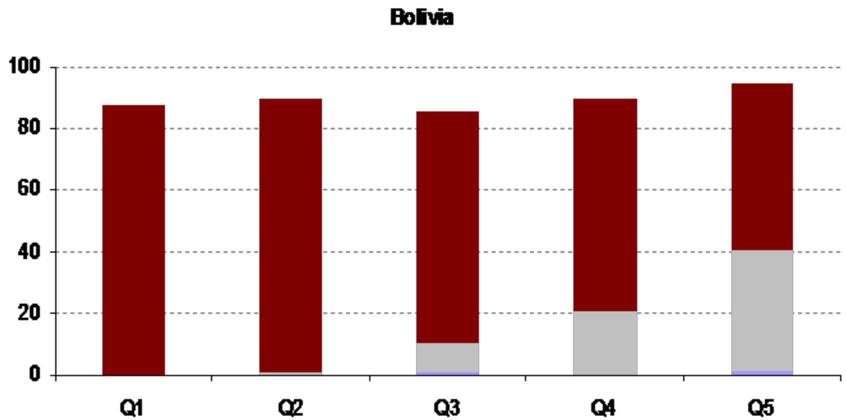
Even those covered are not covered all the time

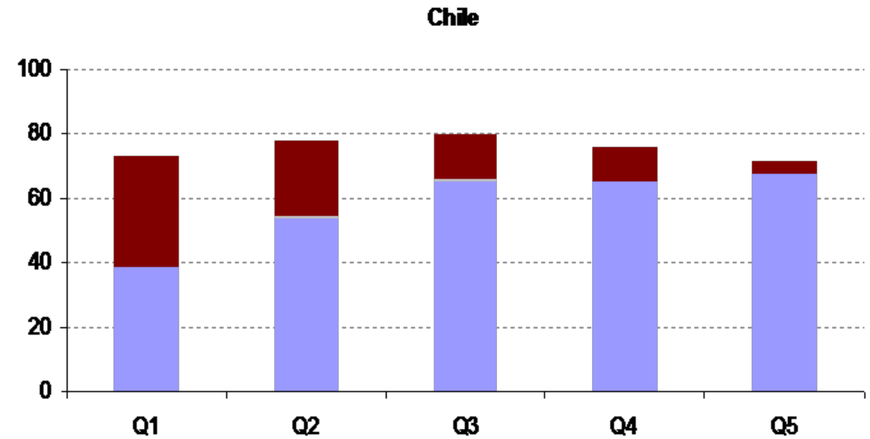


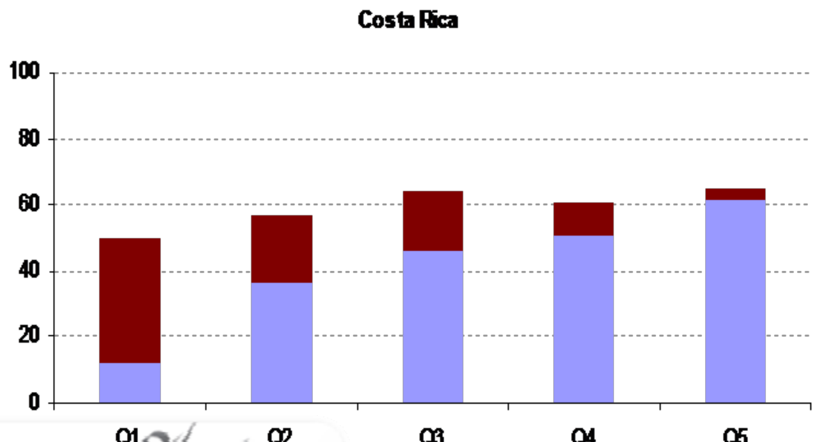
Source: Ribe, Robalino, and Walker (2010)

Non-contributory systems help but total coverage is still far from universal…

Pension Coverage by Income quintiles





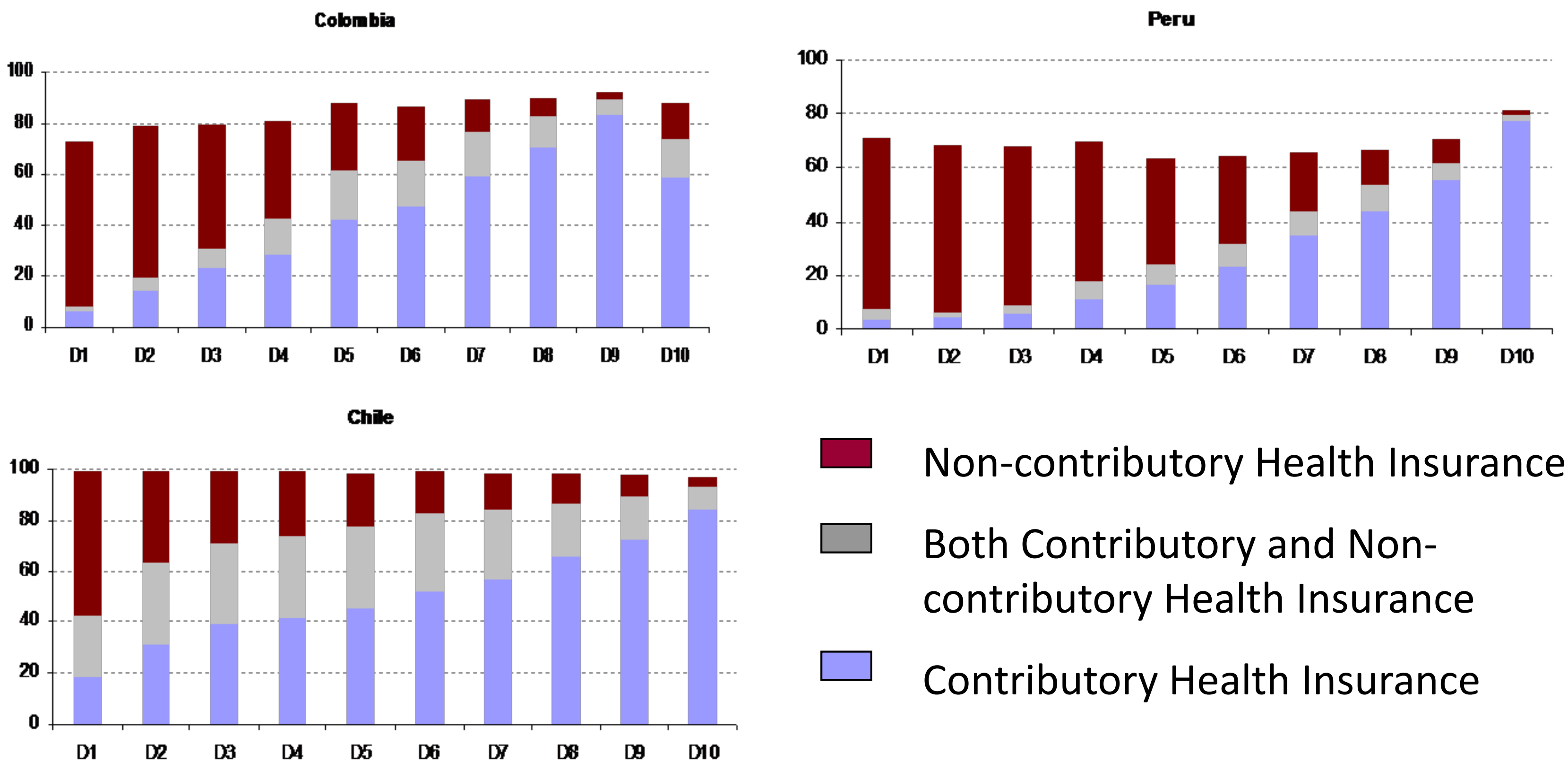


- Non-contributory pensions
- Both contributory and non-contributory pensions
- Contributory pensions

Source: Ribe, Robalino, and Walker (2010)

…leaving a “missing middle”, in health as in old age income coverage, in most places

Health Insurance Coverage by Income Decile



Source: Ribe, Robalino, and Walker (2010)

SI AND LABOR MARKET INCENTIVES

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What are the possible distortions ?

ON THE SUPPLY SIDE

Source		Distortion		Source
		Incentives to search for and keep jobs	←	**Unemployment Benefits**
Lack of access to unemployment benefits	→	Incentives to switch jobs	←	**Lack of SI benefits portability**
Tax component of SS contributions	→	Incentives for informal vs. formal work	←	**Subsidies to informal workers**
Pensions	→	Incentives for participation in the labor force		

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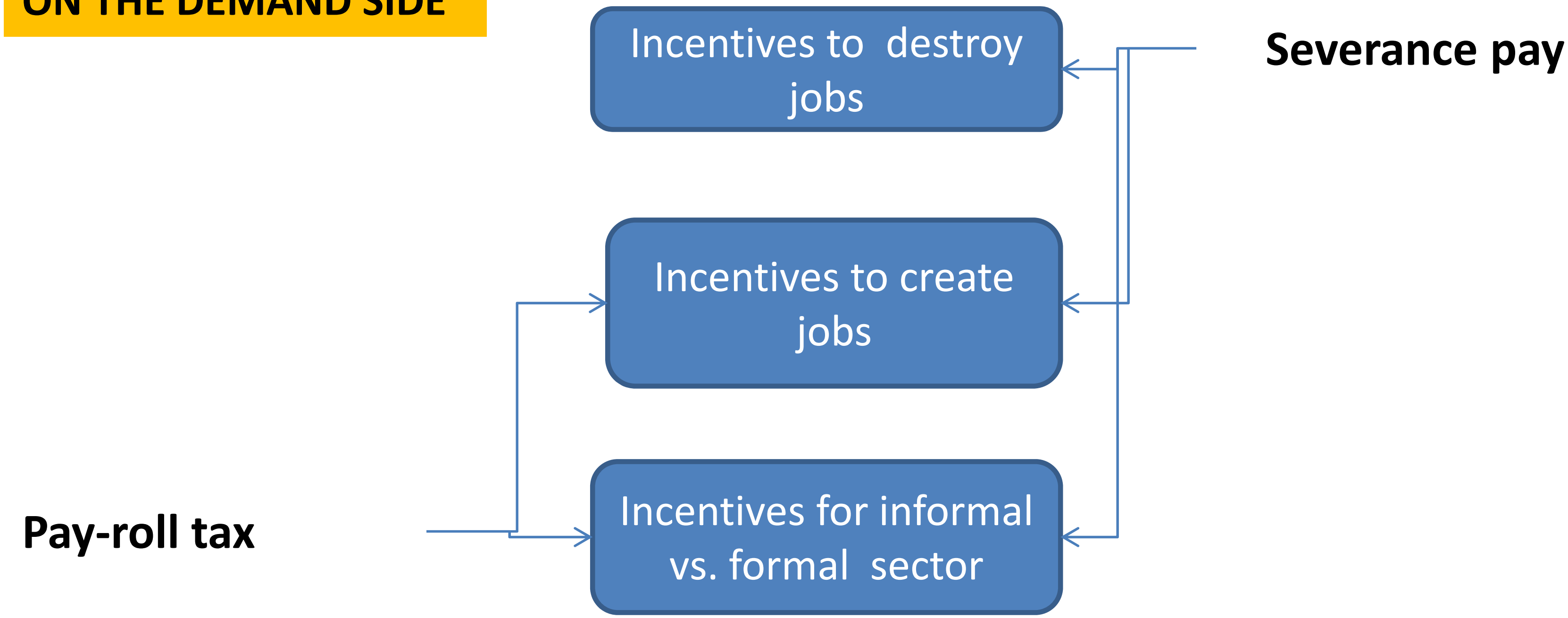
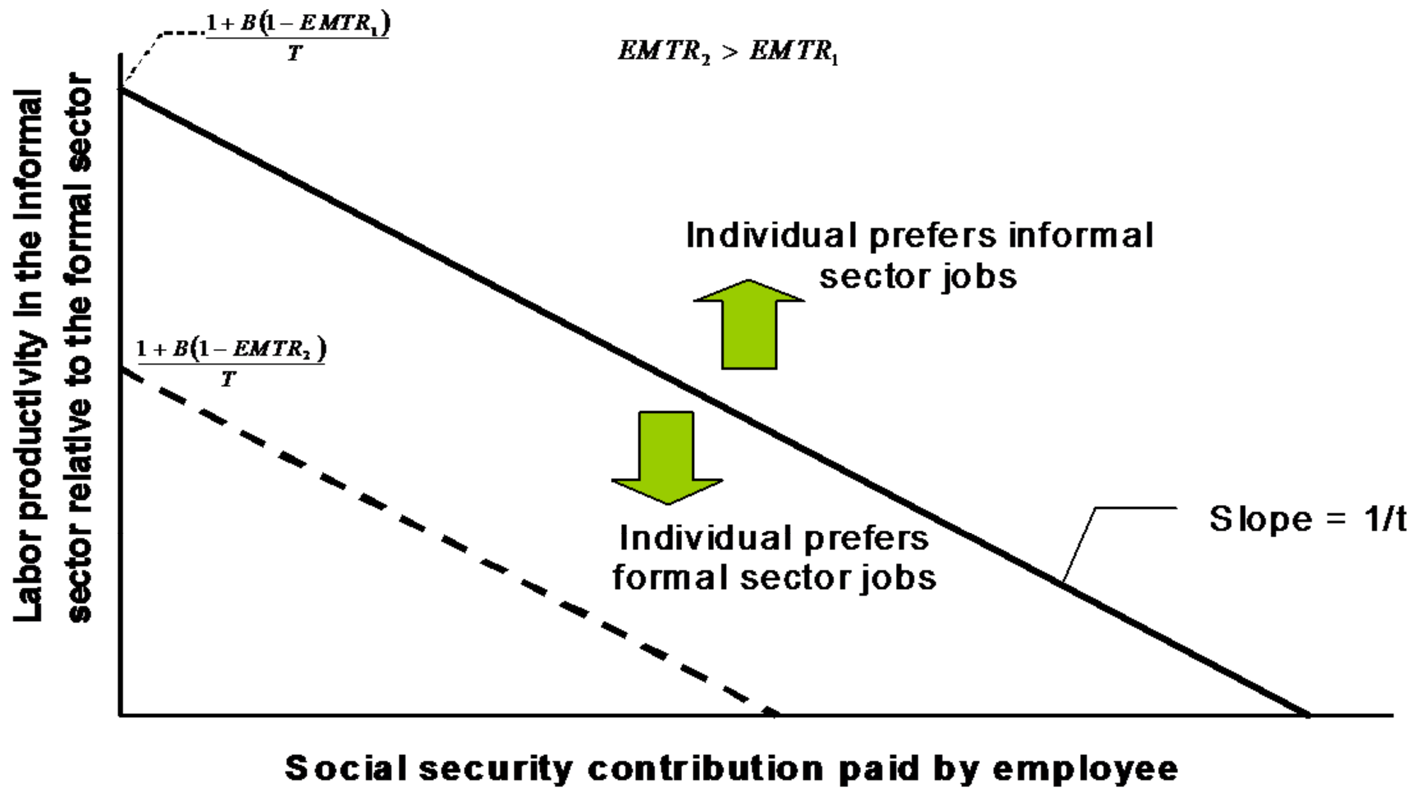
What are the possible distortions ?

ON THE DEMAND SIDE



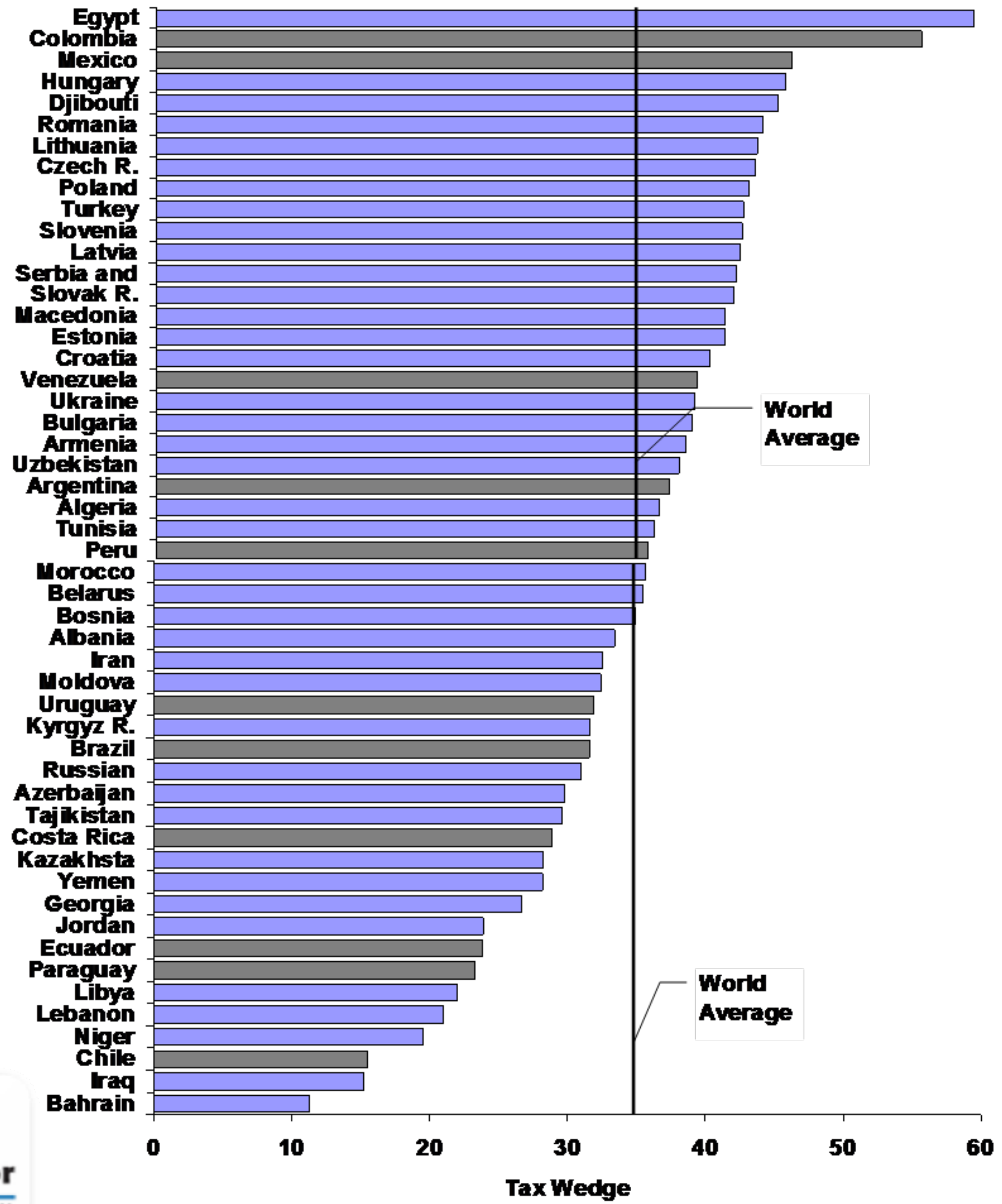
Informal Sector Productivity, Payroll Taxes, EMTRs, and Incentives for Informality



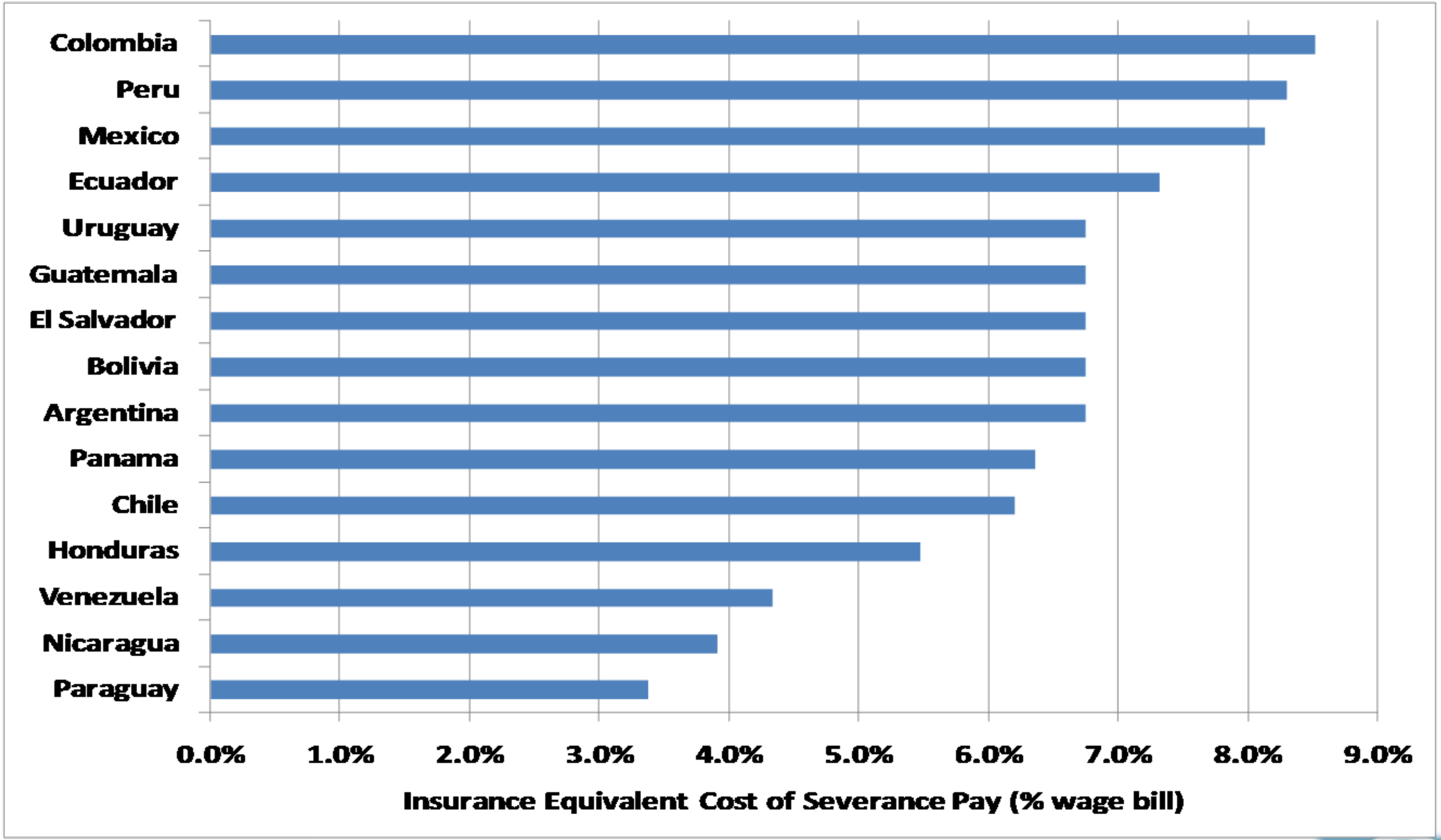
Source: Authors' calculations.

Note: The slope of the line depends on the employer's payroll tax (T), which affects the total cost of labor in the formal sector, here assumed to be equal to labor productivity. The interception of the lines with the Y axis depends on the employee contribution rate, the value of the transfer (B), and the EMTR. Along the lines, the differences in labor productivity between the formal and informal sectors are equal to the tax wedge. Along the dotted line, the EMTR is higher than along the solid line.

Tax-wedge is high in many countries



Severance pay can also be costly



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CONCLUSIONS

Expanding SI coverage

- Expanding SI coverage requires opening access beyond the formal sector where membership can be imposed
  - All citizens/residents would register in the same social insurance system – regardless of where they work.
- SI systems should generally link contributions to benefits
  - Defined contributions can reduce tax element, reduce gaming and help increase voluntary demand for SI
  - This does NOT require funding , but it DOES require transparency, credibility and generous rates of return

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The role of matching contributions

- Impossible to enforce enrollment outside formal sector
- Incentives needed for those with low productivity, limited savings capacity and high personal discount rates
- Subsidies should ideally be:
  - **Explicit**, financed as much as possible from **general revenues**
  - **Targeted** (cheaper) with **gradual withdrawal rates** (minimizing EMTR; distortion is then contained and better managed)
  - **Ex ante** (to incentivize contributions) rather than ex-post (potentially reducing savings demand)
- Matching contributions can produce attractive returns in the very short term and help offset skepticism

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What else might be needed to make this work on the ground?

- **Flexibility** in required contributions, to respond to fluctuating incomes
- **Aggregators** to lower transaction costs
- **Promotion** and marketing strategies
- **Mobile agencies**, to reach out to the potential market
- **Institutional credibility**

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Thank you